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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
	)	
Allocation of Costs Associated with	)	CC Docket No. 96-112
Local Exchange Carrier Provision of	)	
Video Programming Services	)	

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REPLY COMMENTS OF TELE-COMMUNICATIONS, INC.

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Tele-Communications, Inc. ("TCI"), by its attorneys, hereby submits its reply comments in response to the Commission's Notice of Proposed Rulemaking in the above-captioned proceeding.[1]

INTRODUCTION AND SUMMARY

In the Telecommunications Act of 1996, Congress recognized that regulated incumbent local exchange companies ("ILECs") have a powerful incentive to subsidize their entry into competitive markets by shifting costs to their regulated ratepayers.[2] In recent years this cross-subsidization has been especially acute as ILECs deploy broadband networks for the purpose of providing video services to their telephone customers. Accordingly, TCI supports the Commission's proposal to establish "fixed factors" for allocating ILEC costs among regulated and non-regulated services.

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[1] Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services, FCC No. 96-214 (released May 10, 1996) ("Notice").

[2] See 47 U.S.C. § 254(k).

There is no basis for the Commission to entertain various ILEC proposals to impose the same cost allocation requirements on cable operators that the agency determines are appropriate for ILECs. Because the vast majority of cable operators are not subject to cost-based rate regulation, they have no incentive to shift costs between services. Even with respect to those few systems that make use of cost-of-service regulation, there is no evidence that current cable cost allocation rules are inadequate to accommodate cable entry into telephony. Moreover, the costs of imposing complex allocation rules for the 33 months that remain before rate regulation for cable programming services sunsets far outweigh the minimal dangers of cross-subsidization. Application of such rules to cable operators at this time would only serve to inhibit their entry into the market for telephony services, depriving consumers of choice and perpetuating the ILEC monopolies.

I. THE NATURE OF ILEC REGULATION JUSTIFIES THE IMPOSITION OF COST ALLOCATION RULES

Some ILECs argue that any cost allocation requirement imposed on them should also be imposed on cable operators that provide telephony services[3/] or on all telecommunications carriers generally.[4/] SNET, for instance, asserts that "[o]nce the Commission has determined what cost allocation requirements it will apply to LECs, it should immediately apply those same requirements to incumbent cable TV operators."[5/]

[3/] Comments of the Southern New England Telephone Company ("SNET Comments") at 22-24.

[4/] Comments of Ameritech at 9 ("Ameritech Comments").

[5/] Contrary to SNET's assertion, the Commission never has "recognized" that cable and LEC cost allocation rules "should be identical." SNET Comments at 22-23. Indeed, in a Petition for Partial Reconsideration of the FCC's Cost Allocation Second Report and Order filed earlier this year, SNET acknowledged -- and complained about -- the Commission's

These proposals overlook the purpose of imposing cost allocation requirements, a purpose not served by indiscriminately extending their application to others. Cost allocation is a tool for achieving certain regulatory objectives, not an end in itself. The allocation of costs between regulated and unregulated services is an integral part of regulations that constrain pricing by entities whose prices depend on their reported costs. The objective of cost allocation rules, which has long been understood, is to prevent regulated carriers from shifting reported costs to their regulated operations so that they can cross-subsidize the pricing of their offerings in unregulated markets.[6] Historically, cost allocation rules have been a major element of the regulation of local exchange companies. In sharp contrast, they have played virtually no role in the regulation applied to most cable systems.

For a rate-of-return telephone company, the necessity for cost allocation rules is abundantly clear: the prices of its regulated services depend directly on their costs, which in turn depend on what costs are allocated or attributed to those services. While the Commission has adopted a form of price cap regulation for the largest ILECs, costs -- and thus cost allocation -- continue to play a significant role in the form of regulation actually in

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failure to "harmonize" its LEC and cable operator regulatory policies. In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992; Rate Regulation and Adoption of a Uniform Accounting System for Provision of Regulated Cable Service; Second Report and Order, First Order on Reconsideration, and Further Notice of Proposed Rulemaking, 11 FCC Rcd 2220, 2222 (rel. Jan. 26, 1996), Petition of the Southern New England Telephone Company for Partial Reconsideration, filed February 26, 1996. Notably, SNET quotes the disputed passage from that order here for the proposition that the Commission has already determined that the cost allocation rules should be the same for cable operators and LECs. SNET Comments at 23.

[6] For a detailed analysis of this issue, see T. J. Brennan, "Why Regulated Firms Should Be Kept Out of Unregulated Markets: Understanding the Divestiture of United States v. AT&T," The Antitrust Bulletin, XXXII, 3, at 741-794 (Fall 1987).

effect. This is so because Federal LEC price cap regulation is not a "pure" price cap regime, in which prices are regulated with no actual or prospective examination of the costs or rate of return of the regulated carrier. Rather, the Federal rules allow for profit sharing.[7] Under the FCC's rules, moreover, each company may choose the sharing formula and productivity adjustment factor to which they will be subject.[8] The higher the productivity factor chosen by a company, the smaller the share of any excess earnings it must share with consumers, and companies that choose the highest productivity factor of 5.3 percent need not share at all. Most LECs have, in fact, made this choice.

Costs and cost allocations, however, continue to play a role in rate regulation even for a LEC that has chosen the highest productivity factor and no sharing. Under FCC rules, a LEC chooses its productivity factor and the associated sharing rate each year. A LEC not subject to sharing in one year, because it has chosen the highest productivity factor, may choose a lower productivity factor, which makes it subject to sharing in the next year. If it does so, its costs will affect the prices it is allowed to charge in that year.

Moreover, the company's choice from the "menu" of productivity factor/sharing rates that are available is presumably affected by its expected costs and returns from doing so. A LEC may be able to increase its return by choosing a low productivity factor, which permits it to charge higher prices for regulated services than it otherwise could, and an associated

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[7] Under the profit sharing formula, price cap indices are adjusted upward or downward when the ILECs earn a return that is sufficiently below or above a prescribed rate of return. In this form of regulation, the carrier shares some portion of excess earnings with consumers or consumers share some portion of any earnings shortfall.

[8] See 47 C.F.R. § 61.45.

high sharing rate if it can shift costs to the regulated services and thus lower the apparent "profits" from its regulated services in which consumers otherwise might share.

In addition, a LEC's costs and rate of return, and thus cost allocations, may be considered in periodic reviews of the price caps, and may therefore affect the prices the LEC is allowed to charge in the future. A LEC will therefore care about current cost allocations because they will affect future prices.

II. THERE IS NO JUSTIFICATION FOR APPLYING COST ALLOCATION RULES TO CABLE OPERATORS

Cost allocation requirements are a tool without a purpose for suppliers whose prices are not regulated based on cost. Today, cost allocation plays no role in the rate regulation of the vast majority of cable systems. The Commission's primary tool for regulating these rates is a set of benchmarks that are based on the rates charged by other cable operators, not the costs of the operator itself Because a cable system's costs are not considered in determining the rates it can charge for services, this regulatory plan is far closer to a pure price cap plan than the price cap regime applicable to ILECs,[9] and cost allocations are irrelevant to the prices cable systems are allowed to charge under such plans.[10]

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[9] Although an operator subject to benchmark regulation may adjust its per channel rates for changes in "external costs" that exceed the rate of inflation, 47 C.F.R. § 76.922(d), these costs are easily identifiable (e.g., state and local cable taxes, franchise fees, and retransmission consent fees), making it impossible to hide telephony-related costs in this category. In addition, such rate adjustments can only take place on a going forward basis following the establishment of initial maximum rates. This would substantially limit the ability of benchmark regulated cable operators to shift costs in order to overstate their maximum permitted rates.

[10] Comments filed by ILECs themselves support this conclusion. See Comments of BellSouth at 4-5; Ameritech Comments at 5; SNET Comments at 4-5 (cost allocation rules are unnecessary where rates are subject to pure price cap regulation). See also Affidavit of

While cable systems may opt for cost-of-service regulation in lieu of the benchmark formula, this procedure has not been widely used[11] and there is little reason to believe its use will increase in the near future. Indeed, the impending end of most cable rate regulation on March 31, 1999, or earlier[12] will reduce the benefits a cable operator would realize from successfully making a cost of service showing.[13] By contrast, the regulation of ILECs' core services is likely to continue for a significant period of time.

Moreover, cable operators that elect cost-of-service regulation currently are subject to cost allocation rules[14] and there is no indication these requirements are inadequate to accommodate cable entry into telephony. While the Commission recognized that its "current cost allocation rules were not designed for [the] task" of allocating "common costs between the nonregulated offerings that will be introduced by local exchange carriers and the

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Dr. William E. Taylor (attached to SNET Comments) at 5.

[11] TCI has elected cost of service regulation for only four of its systems. In contrast, all telephone companies are either regulated under rate-of-return or a price cap regime that takes into account the costs of providing service.

[12] See 47 U.S.C. § 543(c)(4) (ending regulation of rates for cable programming services on March 31, 1999); id. § 543(l)(1)(D) (cable operator is deemed subject to effective competition in a franchise area in which a local exchange carrier or affiliate offers comparable video programming services there).

[13] Applying cost allocation rules for the short time remaining prior to deregulation would have little effect on investment incentives for cable operators, even if they affected the regulated prices cable operators could charge. The investment cable operators would make in their distribution systems over the next few years will last for a much longer period than will the rate regulation, and therefore will have to be justified based largely on returns expected in an unregulated environment. Cost allocations can have little effect on those expected returns, even if they could somehow affect regulated prices and returns in the meantime.

[14] See 47 C.F.R. §§ 76.923-76.924.

regulated services they already offer,"[15] such concerns have not been shown to exist about the adequacy of the current rules when cable companies provide local exchange services.

In any event, with the end of most cable regulation, cost allocation will be irrelevant to the establishment of cable programming service rates. While rate regulation will continue for the basic tier, there is little danger that cable operators could shift the costs of telephony to basic ratepayers without detection. As noted above, very few operators opt for cost-of-service regulation today and clearly they do not have the ability to hide significant costs in the basic tier, which is generally a low-priced offering that few subscribers purchase without also buying cable programming services. Cost allocation also will serve no purpose as a regulatory tool protecting against cable systems subsidizing their entry into telephony because any "misallocation" of costs would not permit a cable operator to raise its cable programming service rates, and the cable operator would certainly not be able to obtain market power in the supply of telephone service.[16]

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[15] Notice at ¶ 2.

[16] Similarly, no useful purpose would be served by adopting Ameritech's proposal that cost allocation and other Part 64 rules should be applied to all telecommunications carriers. New entrants will neither have, nor have any realistic prospect of acquiring, market power that would justify regulating their rates. Because it will not be necessary to limit the rates they can charge, it is unnecessary to impose cost allocation requirements in order to implement such regulation. For much the same reason, there is no need to impose cost allocation rules to prevent carriers without market power from shifting costs in order to subsidize one service at the expense of another. Unregulated firms with no prospect of gaining market power can only reduce their own profits if they try to "subsidize" one service by misallocating its costs to another service.

III. THE BURDENS OF APPLYING COST ALLOCATIONS TO CABLE OPERATORS WOULD OUTWEIGH ANY BENEFITS

Given the general applicability of benchmark pricing and the imminent end of cable programming services regulation, there is no basis for imposing new cost allocation requirements on cable operators. Even assuming arguendo some marginal benefits from doing so, these benefits would be far outweighed by the substantial costs of developing and implementing an allocation scheme for cable operators.

Contrary to ILEC calls for imposing the "same" allocation requirements on cable companies and new entrants that are imposed on ILECs, it is highly doubtful that cost allocation requirements designed for ILECs would even work if applied to cable operators. First, cable systems are not subject to the Part 64 process and are not required to maintain their accounts according to the Uniform System of Accounts ("USOA") used in Part 64. Cable accounts are not only not maintained according to the USOA, they are not even maintained in a uniform manner across cable systems. There are, of course, good reasons why the Commission has not seen fit to impose USOA or similar requirements on cable systems, but that fact limits the ability of the Commission to apply to cable systems cost allocation requirements that presume the existence of such accounts.

Second, it is doubtful that the same requirements would be appropriate both for cable systems and the LECs, even if cable system accounts were comparable to those of LECs. An allocation of common costs should take into account the stand-alone and incremental costs of the services to which costs are common.[17/] Such costs may vary depending on the

[17/] Notice at ¶ 20.

combination of services offered and the architecture of the networks. Cable systems and ILECs currently have quite different networks and offer different types of service, and are likely to be offering different sets of services in the future.

In addition to the substantial costs of developing separate cost allocation requirements for cable operators, there would be substantial costs to cable systems of complying with those requirements. Literally imposing the same rules on cable operators as those imposed on the ILECs would require cable systems to comply with Part 64 and Part 32 of the Commission's rules. Even modified requirements would make it necessary for cable systems to develop new record keeping systems in order to demonstrate that they were in compliance with cost allocation rules. Such extraordinary costs cannot be justified in view of the public benefits that are meager and short-lived at best.

Of course, the ILECs have strong incentives for advocating the imposition of stringent cost allocation requirements on cable operators and CLECs that have little to do with ensuring fair competition or protecting cable subscribers. The cost of complying with such requirements would, in effect, be an incremental cost of entering the market for local telephone service. Imposing these costs on cable operators and other potential new entrants would inhibit entry and raise the costs that cable operators and others must recover from providing telephone service. Such a result would impede the development of competition and entrench the ILEC monopolies, in direct contravention of the Telecommunications Act of 1996.

CONCLUSION

For the foregoing reasons, the Commission should adopt a cost allocation scheme for ILECs based on fixed factors and should explicitly reject proposals to impose cost allocation rules developed in this proceeding on cable operators providing telephone service.

Respectfully submitted,

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CERTIFICATE OF SERVICE

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